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TESTIMONY OF RICHARD T. McCORMACK

ASSISTANT SECRETARY FOR ECONOMIC AND BUSINESS AFFAIRS

DEPARTMENT OF STATE

BEFORE

THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

JANUARY 27, 1984

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I WELCOME THE OPPORTUNITY TODAY TO APPEAR BEFORE YOUR COMMITTEE TO DISCUSS THE OUTLOOK FOR WORLD OIL SUPPLIES IN 1984 AND THE POTENTIAL IMPACT A DISRUPTION MIGHT HAVE ON THOSE SUPPLIES. OTHER WITNESSES HAVE ALREADY OUTLINED THE FRAGILE NATURE OF THE VITAL OIL SUPPLY LINES THAT PASS THOUGH THE PERSIAN GULF. THIS SITUATION, WHICH WE HAVE HAD TO LIVE WITH FOR MORE THAN 10 YEARS NOW, HAS BECOME EVEN MORE SERIOUS AS A RESULT OF THE WELL PUBLICIZED THREATS IRAN HAS MADE TO STOP ALL OIL FROM LEAVING THE GULF. I WANT TO EMPHASIZE TODAY, HOWEVER, THAT WE ARE MUCH BETTER PREPARED THAN WE WERE TEN YEARS AGO TO DEAL WITH SUCH A SITUATION. I ALSO WANT TO OUTLINE OUR CONTINUING EFFORT TO FINE TUNE OUR ENERGY EMERGENCY PREPAREDNESS.

IN ANY ASSESSMENT OF THE CURRENT PERSIAN GULF SITUATION, IT IS IMPORTANT TO BEAR IN MIND THAT THERE ARE MANY DIFFERENT TYPES OF INTERRUPTIONS THAT CAN OCCUR. THE 1980/81 IRAN-IRAQ WAR, FOR EXAMPLE, RESULTED IN LESS PRODUCTION BY THE TWO COUNTRIES BUT HAD VIRTUALLY NO IMPACT ON WORLD OIL PRICES BECAUSE PRODUCTION INCREASED ELSEWHERE AND STOCKS WERE HIGH. A MORE SERIOUS INTERRUPTION WOULD INVOLVE THE PARTIAL CLOSURE OF THE STRAIT OF HORMUZ. SUCH INTERRUPTION COULD OCCUR THROUGH A PHYSICAL BLOCKAGE, SUCH AS MINING OF THE STRAIT; THROUGH A REFUSAL OF TANKERS OR INSURERS TO ACCEPT THE RISK OF PASSAGE

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INTO THE GULF; OR THROUGH A COMBINATION OF THESE TWO FACTORS. AT THE EXTREME, IF A COMPLETE CLOSURE WERE TO OCCUR, AN OIL FLOW OF UP TO ABOUT NINE MILLION BARRELS PER DAY (MMBD) WOULD BE INTERRUPTED. THE IMPACT OF ANY INTERRUPTION WOULD DEPEND ON THE AMOUNT OF OIL DISRUPTED, THE DURATION OF THE DISRUPTION, AND THE EXTENT TO WHICH OTHER PRODUCERS INCREASED PRODUCTION AND STOCKS WERE AVAILABLE. SUCH A CLOSURE, ALTHOUGH SERIOUS, IS STILL SUSCEPTIBLE TO RELATIVELY QUICK RESOLUTION. INTERNATIONAL PRESSURE OR ACTION COULD RESTORE FREEDOM OF NAVIGATION IN THE GULF.

THE MOST SERIOUS CASE WOULD INVOLVE PREMEDITATED AND CONCERTED DESTRUCTION OF OIL PRODUCTION AND HANDLING FACILITIES IN THE PERSIAN GULF REGION THROUGH, FOR EXAMPLE, SUICIDE AIR OR GROUND COMMANDO ATTACKS AIMED AT KEY CHOKE POINTS, SUCH AS THE HUGE RAS TANURA OIL STORAGE AND LOADING FACILITY IN SAUDI ARABIA.

ALTHOUGH SOME SPARE CAPACITY - PERHAPS 3 MMBD - COULD BE BROUGHT ON STREAM OUTSIDE THE GULF AND PRODUCTION OF OTHER FUELS SUCH AS NATURAL GAS COULD INCREASE, THIS LATTER CASE

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Declassified and Approved For Release 2012/01/13 : CIA-RDP86B00337R000100050015-3

COULD STILL RESULT IN A SHORTFALL OF ABOUT 17% OF FREE WORLD OIL CONSUMPTION -- CLEARLY A MAJOR THREAT TO THE WORLD ECONOMY IF THE DISRUPTIONS LASTED FOR AN EXTENDED PERIOD. IT IS THIS EXTREME CASE, --INVOLVING THE LOSS OF SO MUCH EXISTING AND SPARE CAPACITY--THAT IS SO WORRISOME IN THE MIDDLE EAST TODAY.

IN ANY SUCH CRISIS, INITIALLY SUPPLIES TO EUROPE AND JAPAN WILL BE MORE DIRECTLY AFFECTED THAN OUR OWN. IN THE FIRST NINE MONTHS OF 1983, FOR EXAMPLE, 28% OF EUROPE'S IMPORTS AND 58% OF JAPAN'S CAME FROM THE MIDDLE EAST. A MINISCULE 3% OF U.S. IMPORTS CAME FROM THIS AREA ACCORDING TO THE LATEST IEA STATISTICS. WHILE A DISRUPTION WOULD CLEARLY ALTER THIS PATTERN SOMEWHAT AS EUROPE AND JAPAN SWITCHED TO OTHER SOURCES, OUR STRATEGIC PETROLEUM RESERVE ALONE COULD STILL PROVIDE US WITH 90 DAYS OF IMPORTS AT CURRENT LEVELS.

ALL OF THIS MEANS THAT THE CONSEQUENCES FOR EUROPE AND JAPAN WOULD INITALLY BE MORE SEVERE THAN FOR THE U.S. BECAUSE THEY HAVE LESS DOMESTIC PRODUCTION, GENERALLY LOWER STOCK LEVELS AND GREATER DEPENDENCE ON MIDDLE EAST SOURCES. DUE TO THE EXTENSIVE INTER-DEPENDENCE AMONG OUR ECONOMIES, HOWEVER, THE DISRUPTIONS SUFFERED BY EUROPE AND JAPAN COULD SIGNIFICANTLY AFFECT OUR OWN ECONOMY. IN THE ABSENCE OF STRONG COUNTER-MEASURES, SUCH AS THE RELEASE OF THE SPR, TRADE AND

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MONETARY RELATIONS WOULD BE AFFECTED; OUR BASE RIGHTS COULD WELL BE AFFECTED AT CRITICAL TIMES; WE WOULD ALL BE FORCED TO COMPETE FOR WHATEVER SUPPLIES WERE AVAILABLE; AND PRICE RUN-UPS CAUSED BY PANIC-BUYING IN SUCH A SITUATION COULD BE DAMAGING. HIGHER INTERNATIONAL OIL PRICES WOULD QUICKLY TRANSLATE INTO HIGHER DOMESTIC PRICES. INDEED, IN THE ABSENCE OF CONCERTED INTERNATIONAL EFFORT, THE FOREIGN POLICY CONSEQUENCES FOR THE U.S. OF SUCH A MAJOR CRISIS COULD BE SEVERE.

EVEN A BRIEF LOOK AT THIS PICTURE IS ENOUGH TO SHOW THAT WE MUST MAKE EVERY EFFORT NOW TO PREPARE OURSELVES TO COPE WITH A DISRUPTION AND MITIGATE ITS EFFECTS. FORTUNATELY, WE HAVE A LARGE QUANTITY OF OIL IN THE SPR. ALSO, THE ADMINISTRATION IS CONTINUING ITS REVIEW OF PREPAREDNESS TO DEAL WITH ENERGY EMERGENCIES. THE INTERNATIONAL ASPECTS OF THIS REVIEW ARE BEING DEALT WITH BY THE INTERNATIONAL ENERGY SECURITY GROUP, WHICH WAS CREATED IN 1982 TO DEAL WITH A RANGE OF ENERGY SECURITY ISSUES AND IS CHAIRED BY UNDER SECRETARY OF STATE ALLEN WALLIS. A SIMILAR EFFORT IS BEING LED BY THE DEPARTMENT OF ENERGY. BOTH DEPARTMENTS PARTICIPATE IN EACH GROUP TO INSURE COORDINATION.

Declassified and Approved For Release 2012/01/13 : CIA-RDP86B00337R000100050015-3

Declassified and Approved For Release 2012/01/13 : CIA-RDP86B00337R000100050015-3

I WANT TO ADD ONE SPECIAL NOTE ABOUT THIS EXERCISE. WE ARE AIMING FOR AN OPERATIONAL PRODUCT, ALTHOUGH OBVIOUSLY SOME POLICY AREAS WILL HAVE TO BE REVIEWED TO REACH THAT POINT.

THOUGH WE ARE REVIEWING AND FINE TUNING OUR PLANS IN A NUMBER OF AREAS, GENERALLY SPEAKING THE TOOLS WE HAVE TO WORK WITH IN DEALING WITH AN ENERGY CRISIS ARE CLEAR. IF, DESPITE OUR EFFORTS TO CALM THE SITUATION IN THE GULF, A DISRUPTION WITH SIGNIFICANT IMPACT SHOULD OCCUR, WE WOULD LOOK TO THE INTERNATIONAL ENERGY AGENCY (IEA) AS THE FOCUS OF OUR INTERNATIONAL EFFORT WITH OTHER INDUSTRIALIZED CONSUMERS TO DEAL WITH ANY DISRUPTION. EQUALLY,
WE LOOK TO CLOSE BILATERAL CONTACTS WITH KEY PRODUCERS TO PROMOTE ADEQUATE OVERALL PRODUCTION LEVELS. THE BACKDROP OF THIS ACTIVITY, OF COURSE, WOULD BE THE CONTINUED FUNCTIONING OF THE MARKET TO ALLOCATE SUPPLIES.

WE WOULD EXPECT TO CONSULT WITH LEADING IEA MEMBERS TO DETERMINE AS ACCURATELY AS POSSIBLE THE NATURE AND SCOPE OF THE DISRUPTION AND TO DECIDE WHAT, IF ANY, ACTION IS APPROPRIATE. SHOULD A SIGNIFICANT DISRUPTION OCCUR, WE MAY THEN SUGGEST CONVENING AN EMERGENCY MEETING OF THE AGENCY'S GOVERNING BOARD TO CONSIDER STEPS TO MITIGATE ADVERSE EFFECTS. COOPERATION AMONG INDUSTRIAL NATIONS WOULD BE IMPORTANT IN THIS RESPECT. IN PARTICULAR, SALES FROM STRATEGIC STOCKS

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Declassified and Approved For Release 2012/01/13 : CIA-RDP86B00337R000100050015-3

MAY BE APPROPRIATE. A LACK OF PREPAREDNESS AND TIGHT MARKET CONDITIONS CONTRIBUTED SUBSTANTIALLY TO THE RAPID RISE OF OIL PRICES IN 1973-74 AND AGAIN IN 1978-79. WE ARE FAR BETTER PREPARED TODAY TO AVOID REPETITION OF THOSE EXPERIENCES.

WE WILL ALSO CONSULT WITH OUR IEA PARTNERS ON A RANGE OF ISSUES, INCLUDING SURGE PRODUCTION, STOCK POLICIES AND OTHER RELATED MATTERS.

FINALLY, WE WILL WANT TO DO WHAT WE CAN TO ASSURE THAT WORLD OIL SUPPLIES AND OTHER SUBSTITUTABLE FUELS ARE MAXIMIZED. POSSIBLE STEPS TO BE CONSIDERED INCLUDE 1) IN CASE OF CLOSURE OF THE STRAIT OF HORMUZ, APPROACHES TO STATES WITH PIPELINES LEADING FROM THE GULF TO TRY TO ENSURE THAT THESE PIPELINES ARE UTILIZED TO FULL CAPACITY; 2) IN CASE OF PHYSICAL DAMAGE TO OIL FACILITIES, APPROACHES TO PERSIAN GULF PRODUCER COUNTRIES TO CONSIDER WAYS TO REPAIR THE DAMAGE; AND 3) APPROACHES TO OIL EXPORTING STATES OUTSIDE THE GULF TO SEE HOW MUCH OF THE ESTIMATED 3.0 MMBD IN IDLE PRODUCTION CAPACITY CAN BE BROUGHT ON STREAM SO AS TO SERVE THE NEEDS OF THE WORLD MARKET.

ACTIVATION OF THE IEA EMERGENCY SHARING MECHANISM COULD BECOME NECESSARY AS A LAST RESORT. THERE IS CONSIDERABLE FLEXIBILITY HERE BUT IN GENERAL TERMS DEMAND RESTRAINT FEATURES

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OF THE SHARING SYSTEM ARE INTRODUCED AT A 7% LOSS, AND ALLOCATION AT A LOSS LEVEL OF 12%. WE WOULD MUCH PREFER TO AVOID SUCH AN INTRUSION INTO THE MARKET BUT IF THE NET LOSS OF SUPPLIES TO IEA COUNTRIES EXCEEDS ABOUT 3 MILLION BARRELS (OR A 7% LOSS), WE WOULD CONSIDER WHETHER RECOURSE TO THE EMERGENCY SHARING SYSTEM IS NECESSARY. SIMILARLY, IF ANY ONE IEA MEMBER SUFFERS A 7% OR GREATER LOSS, THERE WOULD BE CONSIDERATION OF WHETHER ACTIVATION OF THE SYSTEM OR SOME OTHER APPROACH SHOULD BE TAKEN.

IN THIS CONNECTION, I WOULD LIKE TO EMPHASIZE THAT OUR ABILITY TO WORK THROUGH THE IEA IS SEVERELY HINDERED BY THE ABSENCE OF EPCA 252 ANTI-TRUST EXEMPTION AUTHORITY. OUR ABILITY TO MEET OUR COMMITMENTS, WHICH IS SO IMPORTANT IN OUR LEADERSHIP ROLE WITHIN THE IEA, IS CURRENTLY SERIOUSLY QUESTIONED AMONG OUR ALLIES. ALL OF THEM BELIEVE THE IEA SYSTEM CANNOT FUNCTION AS DESIGNED IN THE ABSENCE OF THIS AUTHORITY.

IN SUM, MR. CHAIRMAN, THE GULF SITUATION IS VOLATILE AND WE ARE TREATING IT AS SUCH. BASICALLY, WE ARE PREPARED -- DOMESTICALLY WITH MARKET-RELIANCE POLICIES, SUPPLEMENTED BY THE SPR, AND INTERNATIONALLY WITH THE IEA. AND WE ARE FORTUNATE TO

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HAVE A SUBSTANTIAL AMOUNT OF SURPLUS CAPACITY IN THE WORLD MARKET. THE CURRENT EFFORT IS THUS TO BE SURE THAT OUR DOMESTIC AND INTERNATIONAL POLICIES ARE CLEAR AND CONSISTENT AND OUR PLANS ARE READY.

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